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TREASURY FOR ERIC MEYER, JEFF BAKER

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TAGS: EFIN ECON PREL EAID MK
SUBJECT: MACEDONIA: PARLIAMENT APPROVES REBALANCED BUDGET

SENSITIVE BUT UNCLASSIFIED--NOT FOR INTERNET DISTRIBUTION

Summary

¶1. (SBU) On Monday, June 8, Macedonia's parliament approved the Government's rebalanced budget. Although it had been evident to many observers that the GoM budget was wildly out of synch with economic realities, the GoM had resisted an adjustment until after local and presidential elections were complete, and the new President sworn in. The new budget reflects reduced revenues, while keeping the budget deficit at its original target of 2.8 percent of GDP. Most cuts were in capital expenditures. The distribution of these cuts is noteworthy, with defense taking a nearly 20 percent cut that will dramatically limit acquisitions, while the Ministry of Culture's budget grew by 14.1 percent. The new budget also cuts significantly investment in the country's NATO and EU integration in 2009, a disturbing development. The budget is based on GoM expectations that the economy will grow by 1 percent in ¶2009. However, fiscal performance in the first quarter did not support the GoM's previous expectations, and many observers doubt the economy will meet even this target. Further, balance of payments imbalances have triggered a more restrictive monetary policy by the Central Bank, which remains committed to maintaining the denar's peg to the Euro. The GoM has so far chosen to finance the budget deficit through commercial borrowing, rather than through a less expensive IMF loan, although Macedonia's leaders have not ruled out a future IMF program. End summary.

What Triggered Fiscal Adjustment?

¶2. (U) The GOM underestimated the effects of the global economic crisis, in part because the country's somewhat isolated banking system was unaffected by the first wave of financial turmoil, and because the GoM had come to rely on foreign direct investment (FDI) to finance the balance of payments, a policy that was effective through the first half of 2008. However, both FDI and private transfer inflows (including remittances) deteriorated significantly in early 2009, falling by 37.2 percent and 61.4 percent, respectively, in the first quarter of 2009 compared to the same period of 2008. Exports have also fallen by 43.2 percent in the first four months of 2009. Poor performance of Macedonian businesses and the shifting of households toward increased saving helped to lower budget revenues by ten percent from the initial projection for the first quarter of 2009.

Expensive Domestic Borrowing

¶3. (U) Realizing that 5.5 percent GDP growth upon which the 2009 budget was created was too optimistic, the GOM postponed the budget adjustment until after April local and presidential elections. To bridge that period, the GoM borrowed domestically by selling 28-day Treasury Bills at interest rates of about 9 percent. This maneuver tightened denar liquidity in the banking sector and led to a further

reduction of the country's foreign currency reserves, down to 1.167 billion euro by the end of May. This put serious depreciation pressures on the domestic currency, resulting in stricter monetary tightening through increased rates on Central Bank bills and on reserve requirements, as well as changed liquidity requirements for banks.

Slight Budget Cut

¶4. (U) The budget rebalance was spun by the GoM as being part of a larger package of anti-crisis measures. However, the budget was cut only by 6.2 percent, and the deficit target of 2.8 percent of GDP, widely criticized by leading economists and bankers, remains intact. The central government budget (a measure excluding the budget of the extra-budgetary funds - Health Fund, Pension Fund, and Employment Agency) was cut by 9.3 percent, and its deficit lowered from 2.42 to 2.28 percent of GDP. These latest targets are based on a projection for real GDP growth of one percent in 2009, in contrast to the IMF's prediction of minus two percent real GDP growth.

Revenues Down, But Spending is Up

¶5. (U) During the period January - April 2009, total revenues in the central budget were 8.4 percent less than in the same period of the previous year. Tax revenues were down by 8.5 percent, and non-tax revenues by 7.2 percent. Value Added Tax (VAT), the single largest contributor on the revenues side, was down by 5.9 percent. At the same time, total expenditures rose by 21.6 percent compared to the period January - April 2008. Spending on capital projects exceeded last year's by 24 percent, a spending pattern not seen in previous years, when spending was limited until November-December. Current expenditures grew by 21.3 percent, mainly driven by the 30.7 percent increase of transfers, which include transfer for social benefits, local governments, and structural reforms.

¶6. (U) Major revenues in USD million

Type of revenue	2009 budget	2009 rebalance	2009 % of total
Personal income tax	220	200	9.1
Profit tax	223	114	5.2
VAT	922	838	38.0
Excise	314	310	14.1
Import duties	151	141	6.4
Non-tax revenues	364	373	16.9

¶7. (U) Major expenditures in USD million

Type of expenditure	2009 budget	2009 rebalance	2009 % of total
Wages and allowances	529	509	21.1
Goods and services	456	371	15.4
Transfers	1,021	1,007	41.8
Interest	67	57	2.4
Capital expenditures	578	455	18.9

Lower Revenues Across the Board

¶8. (U) With the rebalance, the GOM expects to collect revenues of USD 3.11 billion (Note: The budget is presented in Macedonian denars. Exchange rate used for all calculations: 1 USD = 46 denars.). Central budget revenues are projected at USD 2.21 billion, most of which (76.3 percent) are expected from tax revenues. Tax revenues are projected to be 11.9 percent lower in the amended budget, primarily as a result of expectations that profit tax collections will be almost 50 percent lower than last year. Projected VAT revenues are projected to be 9.1 percent lower than in the original 2009 budget.

Cutting Mostly on Capital Expenditures

¶9. (U) The GOM plans total expenditures of USD 3.36 billion, out of which central government expenditures will amount to USD 2.41 billion. In order to be able to bring expenditures into line with revenues, the GOM decided to cut capital investments by 21.3 percent. Expenditures for wages and allowances, however, were cut

by only 3.9 percent. A 10 percent wage increase for public sector employees, originally planned for October 2009, and new hiring were both cancelled through the end of the year.

¶10. (U) Expenditures for goods and services were cut by 18.6 percent, mainly reducing travel expenses, representation, cell phone usage, as well as honoraria and bonuses for members of various commissions within government administration. Transfers remained approximately at the level of the original 2009 budget in order to provide timely coverage for social benefits, pensions, health services, as well as transfers to local governments.

Defense, NATO and EU Integration Take a Hit

¶11. (U) The Ministry of Defense was one of the big losers in the budget rebalance, taking an almost 20 percent cut. This will result in deep cuts to acquisitions and may result in slowed modernization. Likewise, the budget for NATO integration was cut almost four-fold, from USD 14.1 million to USD 3.6 million, and the budget for EU integration was reduced from USD 20.6 million to USD 6.6 million. The cuts in the GoM's NATO integration program, which is entirely in the hands of the Ministry of Defense, will largely affect supplies, repairs, and maintenance. The rebalanced budget for EU integration will result in fewer funds for building human and institutional capacities within the GoM, but also significantly lower expectations for financing from the EU's IPA funds.

Economic Promotion and Cultural Heritage Continue
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¶12. (U) On the other hand, the GOM is not giving up on culture and promotion of the "New Business Heaven in Europe." The Ministry of Culture's budget was increased by 14.1 percent, with expenditures for building and/or reconstructing "objects of cultural heritage" growing by 29.6 percent. (Note: While we believe this includes funding of statues, churches, and other controversial objects, we have heard through different sources that these projects will be placed on hold or not funded with government money. End Note.) Additionally, promotion of Macedonia in the world's leading magazines, newspapers and TV stations will continue, keeping the planned expenditures at about the level of the original 2009 budget. According to the rebalanced budget, officially the GoM intends to spend about USD 10 million for economic promotion.

Deficit at the Original Target

¶13. (U) With revised revenues and expenditures, the GoM still insists on keeping the general government budget deficit target at

2.8 percent of GDP. This is in keeping with consistent statements by GoM officials that the target deficit would be maintained. To finance the deficit, the GoM has resorted to borrowing domestically by selling government paper, and from abroad by issuing Eurobonds and taking loans from commercial creditors. The GoM continues to view a potential IMF program with suspicion, arguing that it would hurt the country's reputation. However, Minister of Finance Slaveski has stated publically that the GoM would take an IMF program if needed, although this would be a "last resort."

Comment

¶14. (SBU) Although the rebalanced budget makes appropriate adjustments for falling revenues, we and many other observers assess that this budget does not go far enough. Macedonia's external account is worsening, and imports nearly double exports. Central bank currency reserves are down to 1.167 billion euro, down from a September 2008 high level of 1.7 billion. A number of interlocutors have told us that Macedonia will muddle through the summer, a time when economic activity slows and returning diaspora traditionally infuse cash into the economy. However, many see potential problems for the country when activity increases in the fall. If government revenues remain low, a second adjustment to the budget - and perhaps an IMF program to protect the currency peg -- will be unavoidable. End comment.

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